IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

PRUDENCE REALIZATION CORPORATION,

Petitioner,

against

A. JOSEPH GEIST, Trustee,

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF ON BEHALF OF A. JOSEPH GEIST, TRUSTEE

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Jurisdiction

The appellant, Prudence Realization Corporation, by permission of this Court, writ of certiorari granted January 5, 1942 (R. 149), appeals from the determination of the United States Circuit Court of Appeals for the Second Circuit, dated August 11, 1941 (R. 129), which affirmed (Circuit Judge Frank dissenting) the decision of District Judge Grover M. Moscowitz (Eastern District of New York), dated January 5, 1941 (R. 123-125), and the order entered thereon dated January 30, 1941 (R. 125-126), decreeing that certain guaranteed mortgage certificates held by Prudence Realization Corporation, the successor in interest of The Prudence Company, Inc., the guarantor, are subordinate in interest to the certificates sold to and held by the general public.

Statement of Facts

The Prudence Company, Inc., a banking corporation organized under the laws of the State of New York, loaned $480,000 to Zo-Gale Realty Co., Inc., the then owner of premises 202 Riverside Drive, in the Borough of Manhattan, City of New York, and received the bond of that corporation secured by a mortgage on the property owned by it. The due date of said bond secured by the mortgage was subsequently extended to April 1, 1935, and the principal indebtedness eventually was reduced to $390,000 (R. 4).

The Prudence Company, Inc., the mortgagee, upon the receipt from Zo-Gale Realty Co., Inc., of said bond and mortgage, assigned them immediately to an affiliated corporation, Prudence-Bonds Corporation, without receiving any consideration therefor (R. 4). The stock of The Prudence Company, Inc., and of Prudence-Bonds Corporation was held by a parent corporation, New York Investors, Inc. (R. 118). The Prudence Company, Inc., sold to the public guaranteed mortgage certificates using a well-designed scheme and plan to facilitate the sale of those certificates.

Prudence-Bonds Corporation, upon transfer to it of the Zo-Gale bond and mortgage, deposited the securities with a depositary and issued its registered Prudence First Mortgage Certificates or bonds (see specimen, R. 5) in such denominations as were requested and specified by The Prudence Company, Inc., and delivered them to The Prudence Company, Inc., without receiving any consideration therefor (R. 16-117).

This completed the circuit. The certificates were guaranteed by The Prudence Company, Inc., and sold by it to the public. The proceeds of sale went into the treasury of The Prudence Company, Inc., and it was not required to, nor did it, account to Prudence-Bonds Corporation for any part of the proceeds of sale (R. 118).

In the normal course of events, The Prudence Company, Inc., sold $382,000 of the Zo-Gale certificates to the general public, leaving $7,200 unissued certificates with Prudence-Bonds Corporation subject to call by The Prudence Company, Inc. (R. 6-118). In 1932, The Prudence Company, Inc., repurchased two certificates aggregating $800, and as a result of various cancellations became entitled to a certificate for $16.67, a total of $816.67 (R. 6-118). The appeal concerns the unissued certificates of $7,200 and the reacquired certificates of $816.67.

The following is the chronological history of the orders entered in the instant consolidated proceedings:

(1) February 1, 1935, a petition for the reorganization of The Prudence Company, Inc., was filed and approved (R. 4-19).

(2) March 17, 1936, a petition for the reorganization of Amalgamated Properties, Inc., was approved as properly filed in the reorganization proceeding of The Prudence Company, Inc., Debtor (R. 4-21).

(3) February 19, 1938, an order of confirmation was duly made and entered in the Zo-Gale Issue (R. 5).

(4) April 9, 1938, an order of consummation was duly made and entered in re Zo-Gale Issue (R. 7) and A. Joseph Geist, respondent, duly qualified as trustee and acquired title to the bond and mortgage for the benefit of the certificate holders.

(5) May 26, 1939, order confirming plan of reorganization of The Prudence Company, Inc., proposed by the Reconstruction Finance Corporation (R. 22).

The order of confirmation in the Zo-Gale Issue was entered on the 19th day of February, 1938, in the United States District Court for the Eastern District of New York, more than one year before the confirmation of the

plan proposed by the Reconstruction Finance Corporation for the reorganization of The Prudence Company, Inc. Both plans were heard before the same District Judge. The order of February 19th specifically reserved the question of parity (R. 5, 6) of the certificates sub judice.

The amended plan for reorganization of The Prudence Company, Inc., Debtor, as proposed by the Reconstruction Finance Corporation, dated April 12, 1938, with amendments, and as confirmed by the order of District Judge Grover M. Moscowitz (Eastern District of New York), dated May 26, 1939 (R. 64-113), in order to comply with the reservation contained in paragraph 7 of the order of confirmation entered in the Zo-Gale issue on February 19, 1939 (R. 6), and recognizing that by virtue of that order certain assets in the portfolio of The Prudence Company, Inc., Debtor, to wit, unissued or repurchased mortgage certificates in "particular" issues were not on a parity "with other certificates of such issue". See Article IV, "Disposition of the New Company's Assets", paragraph 2(ii) and paragraph 2-a (R. 81-82), wherein it is specifically provided:

> 2(a) "* * * no definitive proration should be made of the value of the Collateral or other security for a particular certificate issue, due to uncertainty whether certificates of such issue held in the Debtor's estate on the Effective Date are on a parity with other certificates of such issue, *the deduction to be made pursuant to the foregoing clause (1) shall be based in the first instance on the assumption that the certificates so held in the Debtor's estate are not entitled to parity*, and an appropriate reserve shall be established by the New Company to provide for the additional distribution to be made to certificate holders of such issue if the Board of Directors shall be later satisfied that such parity exists; the Board of Directors being authorized to discontinue such reserve if and when satisfied that 'such parity' does not exist". (Emphasis supplied.)

The subordination of the Zo-Gale certificates is thus provided for under the very plan for reorganization of

The Prudence Company, Inc., in accordance with the Bankruptcy Statutes. The questions for the Court's consideration arise in the plan of the reorganization of Amalgamated Properties, Inc., Debtor, not the plan of reorganization of The Prudence Company, Inc., Debtor, where the order (R. 125-126) was made and entered declaring the certificates subordinate.

The order of confirmation entered in the consolidated proceeding for the reorganization of The Prudence Company, Inc., Debtor, did not nor could it alter or amend the parity question reserved in the order of confirmation entered in the Zo-Gale proceeding in the matter of Amalgamated Properties, Inc., Debtor, on the 19th day of February, 1938, nor was any attempt made in the consolidated proceedings for the reorganization of The Prudence Company, Inc., Debtor, to procure an order amending the order of confirmation in the Zo-Gale proceedings.

The District Court Judge, who heard both plans, said in his opinion: "No claim of waiver can properly be asserted by the respondent (Prudence Realization Corporation) since this question of parity has at all times been reserved" (R. 124). The reservations set forth in the order of confirmation in the plan for the reorganization of The Prudence Company, Inc., Debtor, Article IV, paragraph 2(a) (R. 82) should also be noted.

This proceeding was instituted in the United States District Court, Eastern District of New York, by A. Joseph Geist, trustee, pursuant to the reservation provision of the order of confirmation in the Zo-Gale issue entered February 19, 1938 (R. 6, 9).

The status of The Prudence Company, Inc., and its relationship with Prudence-Bonds Corporation has been the subject of discussion and review by the Federal Court and the courts of the State of New York. In *In re The Westover*, 82 Fed. (2d) 177, the trustees of The Prudence Company, Inc., Debtor, appealed from an order reducing a claim filed by them as trustees in the reorganization of Westover, Inc., which acquired title to premises No. 253-263 West

72nd Street, New York City. The pertinent facts are set forth in the following extract from the unanimous opinion of affirmance of the United States Circuit Court of Appeals for the Second Circuit, per Chase, C. J., at pages 177-178:

> "The appellants are the trustees of the Prudence Company, Inc., itself a corporation being reorganized under section 77B of the Bankruptcy Act (11 U. S. C. A. § 207). The issues here involved have arisen out of transactions which may be summarized as follows:
>
> The Westover, Inc., the corporate debtor in these proceedings, acquired the title in fee to a parcel of land located at 253-273 West Seventy-Second Street in New York City subject to several mortgages given by former owners in the aggregate principal amount of $1,300,000. On August 12, 1926, the debtor executed an additional mortgage on the premises in the principal amount of $100,000. All of these mortgages were merged in a consolidated first mortgage in the principal amount of $1,400,000 by agreement between the debtor and the Prudence Company, Inc., which purchased the mortgages with its own funds. Afterwards, and on February 10, 1927, the Prudence Company, Inc., assigned these mortgages, so consolidated, together with the bonds secured by them, to Prudence-Bonds Corporation, which is also being reorganized under Section 77B. It will be convenient to refer hereafter to these bonds and mortgages simply as the mortgage. *Prudence-Bonds Corporation paid nothing for the assignment. It was wholly controlled by stock ownership by the same interests which owned all the stock of the Prudence Company, Inc. and took the assignment in furtherance of an arrangement between the Prudence Company, Inc., and itself whereby it would issue participating certificates in the mortgage to be delivered by it to the Prudence Company, Inc., for sale to the investing public.* In carrying out this arrangement Prudence Bonds Corporation did issue such certificates to an amount of $177.22 less than the principal sum of the mortgage and delivered them to the Prudence Company, Inc. The latter company then sold all of such certificates except $23,400 in face value which it retained and the appellants now hold as its trustees * * *." (Emphasis supplied.)

In that proceeding, which is on all fours with the facts in the instant case, there was no dispute that the uncertificated unsold portion of the mortgage was owned by The Prudence Company, Inc.

The Prudence Company, Inc., in the Zo-Gale Issue, as in *In re The Westover*, supra, retained for itself the uncertificated portion of the mortgage which had not been sold to the public, as well as the certificates which it reacquired. It was never intended that Prudence-Bonds Corporation should be deemed the owner of the bond and mortgage assigned to it pro forma.

In *In re Prudence Co.*, 89 Fed. (2d) 689, the Circuit Court of Appeals, Second Circuit, in reviewing an appeal from a decision of the District Court of the United States for the Eastern District of New York relative to the "Lerber Construction Corporation Issue", reviewed the history of participation certificates sold to the general public, the relationship existing between Prudence Company, Inc., and Prudence-Bonds Corporation, and recognized the undisputed fact that Prudence-Bonds Corporation did not pay any consideration for the assignment to it of the bond and mortgage pertinent and considered in that proceeding. We quote from the unanimous opinion of that Court at pages 690, 691:

> "January 9, 1931, a bond and mortgage were executed and delivered to the Prudence Company, Inc., for the principal sum of $675,000., bearing interest at 6 per cent. on premises in the Borough of Bronx, City of New York. July 30, 1931, the Prudence Company, Inc., assigned the bond and mortgage to the Prudence-Bonds Corporation which in turn assigned them to the Bank of Manhattan Trust Company as depositary under a deposit agreement. * * *
>
> Thereafter the Prudence-Bonds Corporation issued to the Prudence Company, Inc., participation certificates bearing interest at 5½% per cent. and the Prudence Company, Inc., sold these certificates to the general public along with its guaranty of principal and interest. * * *

We have already given a general outline of the series of agreements which led up to the issuance of the certificates. They must be looked at as steps in the accomplishment of a single plan. *First there was the assignment of the bond and mortgage without consideration to the Prudence-Bonds Corporation;* * * *."* (Emphasis supplied.)

See also:

In re Prudence Co., 98 Fed. (2d) 559, 560;
In re Prudence-Bonds Corporation, 79 Fed. (2d) 212, pp. 216-217.

The inescapable conclusion is that The Prudence Company, Inc., at all times was the owner of the unissued certificates in the various issues, including the Zo-Gale Issue, and that Prudence-Bonds Corporation had no interest in such certificates whatever. A fortiori, the relationship existing between The Prudence Company, Inc., the guarantor, and the certificate holders was that of guarantor, vendor and guaranteed vendees, or, debtor and creditors.

See, also, *In re The Prudence Co., Inc.*, 82 Fed. (2d) 755 (C. C. A. 2), cert. den. 298 U. S. 685, 56 S. Ct. 787, where, in a like situation as here, the Court declared that the mortgages constituted the property of The Prudence Company, Inc., delivered to Prudence-Bonds Corporation in consideration of the issuance by the Prudence-Bonds Corporation of bonds or certificates, part of the plan for the sale of certificates to the public:

"Each of the appellants is the trustee under one or more trust agreements executed by Prudence-Bonds Corporation under which certain mortgages on real estate and other securities were assigned to the appellants to hold in trust upon the terms stated for the benefit of the owners of bonds issued by Prudence-Bonds Corporation in accordance with the trust agreements. *All these securities had been the property of this debtor who had transferred them to Prudence-*

Bonds Corporation in consideration for the bonds issued by Prudence-Bonds Corporation which were delivered to the debtor." (Emphasis supplied.)

As between The Prudence Company, Inc., and Prudence-Bonds Corporation, it cannot be gainsaid that the certificates constituted the property of The Prudence Company, Inc. This very argument was advanced by The Prudence Company, Inc., Debtor in that case (see opening paragraph of the Court's opinion at p. 757).

Questions Presented

The following questions are presented for review and determination by this Court:

1) Shall the assets of Amalgamated Properties, Inc., Debtor in the Zo-Gale Issue, be distributed ratably without classification between the trustee, representing the guaranteed mortgage certificate holders, and The Prudence Company, Inc., debtor-guarantor, holder of similar certificates, the guarantor having defaulted in performing and fulfilling its guaranty, in the absence of a specific agreement, reserving to such guarantor the right to hold such certificates on a parity with those sold to the public?

1-a) Do the obvious equities estop the defaulted guarantor-debtor from sharing equally in the distribution of the assets available for distribution among the creditors of Amalgamated Properties, Inc., Debtor?

2) Did the Court below err in adhering to the interpretation and construction of the guaranteed mortgage certificates contract of the Court of Appeals of the State of New York (the situs of the contract), which decreed that guaranteed mortgage certificates owned by a defaulted guarantor-debtor are not on a parity with those held by certificate holders generally unless such right is specifically reserved to the guarantor in such certificates sold to the public by the guarantor?

POINT I

The existence of the debtor-creditor relationship precludes and estops The Prudence Company, Inc., and its successors in interest from asserting that the certificates held by it are on a parity with those held by the general public.

The Court of Appeals of the State of New York in reviewing the relationships created by and arising out of the sale of guaranteed mortgage certificates to the public has come to the clear and unequivocal conclusion that ownership interests retained by or reacquired by guarantor companies are subject and subordinate to the certificates sold to the general public and that such guarantor companies are not entitled to share in the distribution of either interest or principal until the certificate holders are paid in full unless the certificates sold and delivered to the public clearly, specifically and unequivocally provide that the guarantor is entitled to share with the certificate holders in the distribution of the moneys received from the mortgagor.

The proceedings at bar are on all fours with the case of *Pink* v. *Thomas*, 282 N. Y. 10. There, the Superintendent of Insurance of the State of New York, as liquidator of the Lawyers Title Guaranty Company, sought to have a certificate which it purchased, as well as the unissued portion of that certificated mortgage which it retained, declared to be on a parity with the guaranteed mortgage certificates which it sold to the public with its guarantee. The Court of Appeals emphatically and conclusively declared that the equitable principles existing between the guarantor-debtor in default and the certificate holder creditors estop the Superintendent of Insurance, as liquidator, from sharing in the assets available for distribution until the certificate holders are paid in full. We quote from the opinion of the Court:

"The Lawyers Title and Guaranty Company owned a mortgage for $42,300. It sold participating certificates therein to third parties to the amount of $40,475. It repurchased one $100 certificate. It at all times retained an interest of $1,825 in the mortgage. The company is now in liquidation. The question presented for determination is whether the plaintiff, as liquidator, is entitled to share pro rata in the proceeds to be received from the mortgaged property with the third parties holding participating certificates. The mortgage company guaranteed to certificate holders the payment of the certificates. If it had not guaranteed the payment of the certificates it would be entitled to share pro rata with the certificate holders in the proceeds of the sale of the mortgaged property (Title Guarantee & Trust Co. v. Mortgage Commission, 273 N. Y. 415), *but if a mortgage company guarantees payment of certificates which it sells to third parties it is not entitled to share in the proceeds received from the sale of collateral until the third-party certificate holders are paid in full unless the certificates sold clearly provide that it retains such right* (Matter of Title & Mortgage Guaranty Company of Sullivan County, 275 N. Y. 347), *the underlying principle being that a mortgage company which sells participating certificates in a mortgage and itself guarantees them is in the position of a debtor, and the equitable rule existing between debtors and creditor applies.* On default and absence of sufficient funds to pay certificate holders other than itself in full it cannot share in the assets available until the certificate holders are paid in full. That is the law, and it is right. Having guaranteed the payment of the certificates it would be highly inequitable to permit it to step in and divert part of the security available to pay such certificate holders whom it had expressly guaranteed should be paid. No one in this case questions that principle.

It should take very clear and unambiguous language in the certificates to overcome that rule and substitute a holding that in spite of its guarantee of payment it should be permitted to share in the available assets even though the certificates which it had guaranteed should be paid remained unpaid. Such

> an inequitable result could be accomplished if the language used was so clear and unmistakable that the courts would be compelled to give effect to the intent of the parties as expressed in the writing. Otherwise the equitable rule should prevail." (Emphasis supplied.)

The Prudence Company, Inc., occupies the identical position and relationship to the guaranteed holders of the Zo-Gale Issue that existed between the Lawyers Title Guaranty Company and its guaranteed mortgage certificate holders. The Court of Appeals refused to construe the certificates issued by the Lawyers Title Guaranty Company as reserving to the guarantor the right to hold similar certificates on a parity with those sold to the certificate holders, and said at page 13:

> " * * * the wording of the certificate does not require the holding contended for by the respondent (Superintendent of Insurance)",

and reversed the judgment of the Appellate Division.

The Zo-Gale certificates were drawn with great care and skill. The precise and concise words incorporated in the certificates were selected with meticulous care and fine discrimination, and their meaning is clear and obvious. The certificates conspicuously omit the reservation in favor of The Prudence Company, Inc., as the guarantor, which would have given it the right to hold similar shares for its own account, but they do specifically reserve that right to Prudence-Bonds Corporation, which is described in the certificates as the "corporation" (Exhibit 1, R. 11-12, 115-116). And then, to emphasize that whatever rights were reserved are specifically defined, the certificates provide that certain rights are reserved "to the corporation and/or guarantor". Particularly the certificates provide in paragraph 4 thereof that only "the corporation (Prudence-Bonds Corporation), may for its own corporate account, be the holder or pledgee of similar shares in the said bond and mortgage" (R. 11).

The Court of Appeals in *Title Guarantee & Trust Co.* v. *Mortgage Commission*, 273 N. Y. 415, carefully considered the relationship created by the sale of a mortgage certificate by a company other than the guarantor, and there held that since the relationship of debtor and creditor did not exist, the Title Guarantee & Trust Company, as distinguished from the Bond & Mortgage Guarantee Company, the guarantor, with other certificate holders, became with them tenants in common, each entitled to an alliquot share of the mortgage referred to in the certificate.

The decision of the Court of Appeals is specifically limited to the facts in that case. See *In re Title & Mortgage Guaranty Company*, 275 N. Y. 347, where the Superintendent of Insurance, as liquidator of the Title & Mortgage Guaranty Company, upon the judicial settlement of the account of a trustee, sought to share as the holder of an unissued portion of a mortgage pro rata with the holders of the guaranteed mortgage certificates of that issue. The Court denied the claim of the liquidator, specifically declaring that the holders of the guaranteed mortgage certificates had a prior right to payment in full out of the proceeds of the mortgage.

In *In re Union Guaranty & Mortgage Co.*, 285 N. Y. 337, 34 N. E. (2d) 245), the Court said at page 343:

> "The principles of law applicable to the assignment of a prior interest in a mortgage are found in the decisions of this court. * * * *In Matter of Title Guaranty and Trust Company* v. *The Mortgage Commission* (273 N. Y. 415) * * *. Where, however, * * * a debtor-creditor relation exists between an assignor of part of a mortgage and the assignee thereof, the assignee's claims must be satisfied before the assignor's.' (*Matter of New York Title and Mortgage Company; Matter of People by Van Schaick* [Series C-2], 253 App. Div. 308; affd., 278 N. Y. 488.)
>
> This rule was followed in the case of *Pink* v. *Thomas* (282 N. Y. 10). In order to avoid this rule an assignor of a part of a bond and mortgage or other assignable chose in action, may, by the terms of the

assignment, fix the right and interests of the assignor and assignee. Thus the rights of the certificate holders to preference may rest not only upon the presumption of intent derived from the guaranty of the assignor, *but also may be determined from the actual intent shown by the provisions of the agreement between the assignor and assignee.* (*Matter of Title & Mortgage Guaranty Co.* [*Pink*], 275 N. Y. 347.)" (Emphasis supplied.)

In *Matter of Weill*, 253 App. Div. 308, affirmed without opinion 278 N. Y. 488, referred to on pages 18 and 19 of the appellant's brief, the Court held that there was no intention on the part of the New York Title Mortgage Company to cancel certain of its guaranteed mortgage certificates, which it repurchased, particularly since the certificates explicitly provided:

> "This certificate is one of a series of certificates * * * wherein the Company covenants * * * and hereby agrees to and with each and every holder of this certificate, as follows: That there shall be no preference or priority in favor of any share in the deposited bonds and mortgages * * * or of any certificate of interest. * * *
>
> * * * * * * *
>
> 2. The Company may be the holder or owner or pledgee of one or more of the said certificates."

The depositary agreement provides:

> "8. There shall be no preference or priority in favor of any share in the deposited bonds and mortgages * * * or of any certificate of interest representing the same, as against any other share or certificate, whether held by the Title and Mortgage Company or by any other holder; but each share shall participate equally with every other share in the deposited bonds and mortgages * * *".

and the certificates therefore were properly determined to be on a parity with all the other outstanding certificates, and for those reasons the Court said that the certificates "should be regarded as a substitute for such of the general assets as was used to purchase them" (p. 310).

A close examination of the guaranteed mortgage certificate and the guaranty agreement executed by The Prudence Company, Inc., leads to the inevitable conclusion that an actual agreement exists between The Prudence Company, Inc., and the certificate holders subordinating the claims of The Prudence Company, Inc., to those of the certificate holders and should be decreed so by this Court (*Thomas* v. *Pink*, supra). The Prudence Company, Inc., under its agreement of guaranty, "* * * guarantees to each and every holder of the certificates of participation * * *

> First: Payment of interest when due according to the terms of each such certificate issued.
>
> Second: Payment of the principal, and of every installment thereof, as soon as collected, but in no event later than eighteen months after it shall have become due and payment thereof shall have been demanded in writing by the insured, with regular payment meantime of interest at the rate guaranteed" (R. 12-13).

The Circuit Court of Appeals in its decision in the case at bar said (122 Fed. [2d] 503; R. 132-136):

P. 132.

> "And if we thus found the guarantee to amount to an actual agreement between two creditors that the claim of one against the debtor should be subordinated to that of the other, we should give that effect to it, as was done in *St. Louis Union Trust Co.* v. *Champion Shoe Machinery Co.*, 8 Cir., 109 F. 2d 313; *Bird & Sons Sales Corp.* v. *Tobin*, 8 Cir., 78 F. 2d 371, 100 A. L. R. 654; and *Searle* v. *Mechanics' Loan & Trust Co.*, 9 Cir., 249 F. 942, *certiorari* denied 248 U. S. 592, 39 S. Ct. 67, 63 L. Ed. 437 * * *."

P. 133.

> "Where the state law determines what the actual agreement made by the parties is, and therefore the real basis of their claims in bankruptcy, it must be given effect."

P. 136.

"Moreover, these appear to be no particular equities in favor of either the original guarantor or those who claim through it, including its successor * * * which took with full notice of the situation from the reorganization proceedings generally and especially in view of the explicit reservation of the question in the confirmation of the debtor's reorganization."

P. 136.

"Under *Pink* v. *Thomas*, *supra*, *an actual agreement against parity might well be found*." (Emphasis supplied.)

See:

In re Title & Mortgage Guaranty Company, supra.
Harv. L. Rev., Vol. LV, No. 2, Dec. 1941, p. 283, Note

The petitioner discusses at great length the relative position of the creditors of The Prudence Company, Inc., and devotes much of its brief to this alien question. We are here concerned with the creditors of Amalgamated Properties, Inc., and it cannot be gainsaid that all the equities are overwhelmingly in favor of the guaranteed mortgage certificate holders of the Zo-Gale Issue and that none of them lie with the guarantor, The Prudence Company, Inc.

See:

Pink v. *Thomas*, supra;
In Matter of Title & Mortgage Guaranty Company, supra;
Title Guarantee & Trust Co. v. *Mortgage Commission*, supra;
In re The Westover, supra;
In re The Prudence Company, Inc., supra.

The bankruptcy theory and rules of equal distribution generally applied in insolvency proceedings are inapplicable where special equities exist. See: *Sampsell* v. *Imperial Paper & C. Corp.*, 313 U. S. 215, 221, 61 S. Ct. 904, 85 L. Ed. 1293, where this Court said:

> "The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete. Taylor v. Standard Gas & E. Co., 306 U. S. 307, 83 L. ed. 669, 59 S. Ct. 543, 38 Am. Bankr. Rep. (N. S.) 692; Pepper v. Litton, 308 U. S. 295, 84 L. ed. 281, 60 S. Ct. 238, 41 Am. Bankr. Rep. (N. S.) 279; Bird & Sons Sales Corp. v. Tobin (C. C. A. 8th), 78 F. (2d) 371, 100 A. L. R. 654, 29 Am. Bankr. Rep. (N. S.) 171."

See, also:

St. Louis Union Trust Co. v. *Champion Shoe Machinery Co.* (8th Cir.), 109 Fed. (2d) 313;
Bird & Sons Sales Corp. v. *Tobin* (8th Cir.), 78 Fed. (2d) 371, 100 A. L. R. 654.

The application of this principle, however, should not be confused with erroneous attempts to administer insolvency proceedings in accordance with local laws contrary to the provisions of the Bankruptcy Law.

Yonkers v. *Downey, Receiver*, 309 U. S. 590, 597, 60 S. Ct. 796, 84 L. Ed. 964;
Jennings, Receiver v. *United States Fidelity & Guarantee Co.*, 294 U. S. 216, 55 S. Ct. 394, 79 L. Ed. 869, 99 A. L. R. 1248.

The trustees of The Prudence Company, Inc., actively participated in the Amalgamated Properties, Inc. proceeding. They acquiesced to the reservation proviso; the Court had jurisdiction of all the parties and the collateral attack attempted here will not lie. Cf. *Stoll* v. *Gottlieb*, 305 U. S. 165, 59 S. Ct. 134, 83 L. Ed. 104.

A Review of the Contentions Urged by the Petitioner

The petitioner urges in Point V of its brief that the certificates are entitled to parity in any event because they were originally in the name of Prudence Bonds Corporation and transferred to the trustees of The Prudence Company, Inc., Debtor, as a compromise pursuant to an order of the District Court. That contention was urged and disposed of in the opinion of District Judge Moscowitz, who heard and passed upon the plans of reorganization of both Amalgamated Properties, Inc., Debtor, and The Prudence Company, Inc., Debtor:

> "The difficulty with the respondent's analysis rests in the assumption that its uncertificated interest was derived from the reorganization compromise and that the compromise agreement implied parity. Actually, however, the uncertificated interest of the respondent was not wholly derived in that manner. It should be remembered that the assignment of mortgage from Prudence to Prudence Bonds was without consideration, and that therefore, to the extent that mortgage certificates were not delivered by Prudence Bonds to Prudence, the real ownership, as between the parties, remained in Prudence. When, therefore, in connection with the reorganization compromise, Prudence Bonds released to Prudence any interest it might have in the uncertificated portion of the mortgage, that release did not effect the transfer to Prudence of any substantial interest that it did not already have as against Prudence Bonds. Accordingly, there is no basis for disregarding the rule set forth in Pink v. Thomas, supra" (R. 124).

The petitioner also stresses the decision of Judge Brower in *Matter of Southeast Corner of National Boulevard and West Broadway, Long Beach*, reported in the New York Law Journal January 31, 1940. The decision in that case is in complete harmony with the decisions of the Court of

Appeals. There, the Superintendent of Insurance, as liquidator of the Bond & Mortgage Guaranty Company, in the regular course of business, purchased a mortgage certificate from the Title Guarantee & Trust Company after the entry of the order for the rehabilitation of the Bond & Mortgage Guaranty Company. Since the relationship of debtor, guarantor and creditor did not exist, the Title Guarantee & Trust Company was entitled to have the certificates held by it declared on a parity with those held by the general public, and the purchase of such a certificate by the Superintendent of Insurance after the entry of the order of rehabilitation as a business transaction could not destroy the right to parity. The position of the petitioner, on the contrary, is singularly parallel to that of the Bond & Mortgage Guaranty Company prior to the entry of the order of liquidation—a guarantor-debtor in default, who did not reserve the right to and could not hold certificates on a parity with those sold to the general public.

The petitioner urges in Point III of its brief that the certificates held by it are on a parity with those held by the trustee because it owns Amalgamated Properties, Inc., and as a creditor of The Prudence Company, Inc., Debtor, accepted the stock of Amalgamated Properties, Inc., as security for a loan which it made to The Prudence Company, Inc. The Court of Appeals of the State of New York refused to recognize this contention in *Matter of Lawyers Title & Guaranty Company, Netacos Corporation*, decided January 15, 1942, published in the New York Law Journal February 20, 1942, 287 N. Y. 264, Vol. 146, Official Weekly Advance Sheets.

In that case, the Lawyers Title & Guaranty Company, prior to its liquidation, was the owner of a bond and mortgage in the principal amount of $75,900 which it sold with its guaranty on February 8, 1927 to Adele Kneeland, as executrix. Upon maturity of the mortgage, the property having been appraised for less than the mortgage,

the company paid $25,000 of the principal of the mortgage to the executrix and issued to her a guaranteed first mortgage participation certificate for $50,000. This guaranteed mortgage certificate, hereinafter referred to as certificate No. 1, was sold to the Netacos Corporation, the present holder thereof.

On January 26, 1933, the Reconstruction Finance Corporation loaned to the Lawyers Title & Guaranty Company a large sum of money, and as part of the collateral security for that loan received an assignment of a guaranteed mortgage certificate for $25,000, hereinafter referred to as certificate No. 3, the balance of the above described mortgage. When it appeared that the value of the property was insufficient to pay on liquidation the face value of the two certificates, the proceeding was instituted, Netacos Corporation urging that its certificate was superior in interest and priority over the certificate pledged with the Reconstruction Finance Corporation and that the liquidator of the Guaranty Company and the Reconstruction Finance Corporation had the right to receive only so much as may remain after paying principal and interest on the certificate held by the Netacos Corporation.

The Court of Appeals sustained the contention of the Netacos Corporation. The opinion of the Court follows:

> "Both Certificate No. 1 (originally sold to the Kneeland estate and later acquired by The Netacos Corporation) and Certificate No. 3 (pledged by the company to R. F. C.) contain a provision assigning to the holder thereof an undivided share in the bond and mortgage No. 'Q' 25088 'equal and co-ordinate with all other shares assigned or retained by the Company, the aggregate amount of all such shares, issued and retained, at no one time to exceed the amount then owing on said bond and mortgage'. We read the provision in the light of the explanation given in *Pink* v. *Thomas* (282 N. Y. 10, 13): 'As we know, these mortgage certificates are sold at different times to different individuals. The words "equal and co-ordinate with all other shares assigned or retained

by the Company" constitute an agreement that the shares in question shall be equal and co-ordinate with those previously *sold*. That is, that the date of *sale* of different shares shall not in any event constitute a preference, and the shares retained by the company at the date of the sale of any particular share are retained presumably for subsequent *sale*, as that was the business of the company. They shall, *when sold*, be equal and co-ordinate with those in question and all other shares previously *sold* or those still remaining and retained by the company to be thereafter *sold*. All shares taken together, that is, all those sold and all those unsold but retained for future sale, shall not exceed the amount at any time owing on the bond and mortgage'." (Emphasis supplied.) (See, also, *Matter of Title & Mortgage Guaranty Co.*, 275 N. Y. 347).

"It cannot be doubted that, under the rule of *Pink* v. *Thomas* (*supra*), if, instead of pledging Certificate No. 3, the company had retained that certificate for itself, Certificate No. 1 would be entitled to priority. Nor can there be doubt that if, instead of pledging Certificate No. 3, the company had *sold* that certificate to R. F. C., Certificate No. 1 would share in the security pro rata with Certificate No. 3. In the present proceeding, however, Certificate No. 3 was not sold—it was pledged to R. F. C. by the company as collateral to its loan. In that transaction R. F. C., as pledgee, acquired what may be termed a special property in the hypothecated certificate—a 'possessory right acquired under the bailment' (*McCoy* v. *American Express Co.*, 253 N. Y. 477, 482). But the general property—the legal title to the certificate—remained in the company as pledgor. (*Markham* v. *Jaudon*, 41 N. Y. 235, 240, 241; *Keller* v. *Halsay*, 202 N. Y. 588, 597. Cf. *Griffey* v. *New York Central Ins. Co.*, 100 N. Y. 417, 422; *Harding* v. *Eldridge*, 186 Mass. 39, 42.)

This proceeding and those involving similar problems call for a determination of the intention of the parties and a consideration of the natural equities involved. (*Matter of Title & Mortgage Guaranty Co.*, supra, pp. 354, 355; *Pink* v. *Thomas*, supra; *Matter of People* (*Union Guarantee & Mortgage Co.*), 285 N. Y. 337, 344.) The fact that we are dealing with a guaranty by the company bears upon those equities.

When the company offered to sell participation certificates in the mortgage here involved it must have been the intention of the seller and the understanding of the buyer that only purchasers who placed themselves in positions akin to mortgagees would be entitled to the preferential benefits attaching to the guaranteed certificates. The sale of participating interests in mortgages was the business which engaged the company's efforts. Not only the mortgage security but the company's guaranty must have been intended as favorable competitive factors in the mortgage market. It is with that assumption in mind that we read the phrase common to Certificates Nos. 1 and 3 whereby the company assigned an undivided share in the bond and mortgage, 'Equal and co-ordinate with all other shares assigned or retained by the Company.' Thus read, and with proper regard for the ruling in *Pink* v. *Thomas* (supra), the quoted phrase refers to shares *sold* to a *purchaser* of the certificates, viz., to one who, by reason of the acquisition of the rights represented by the certificate, became entitled to participate in the mortgage security and any benefits arising from the guaranty *pro rata* with the purchasers of other participation certificates in the same mortgage, or their assignees.

We do not believe that when the company pledged Certificate No. 3 with R. F. C. as collateral to a loan, it granted to R. F. C. as pledgee the same rights as those to which a *purchaser* of other similar certificates was entitled. The company could pledge no rights in the certificate which it could not exercise itself. * * * The company cannot retain the legal title to the certificate—as it does as a pledgor (*Markham* v. *Jaudon*, supra, pp. 240, 241)—and enjoy additional rights or advantages solely by reason of the fact that it has pledged the certificate. * * *

The order of the Appellate Division should be modified to provide that Certificate No. 1 of mortgage No. 'Q' 25088 shall be entitled to priority over the interest of both the liquidator and R. F. C. in Certificate No. 3."

The petitioner in Point IV of its brief cites *In the Matter of The New York Title & Mortgage Company*, 163 Misc. 318, 296 Supp. 644, affirmed without opinion 254 App. Div.

722, 4 N. Y. Supp. (2d) 1004, in support of the proposition that the New York State courts have determined that certificate holders do not have a prior lien in a mortgage as against the guarantor which holds similar certificates. That decision does not support that theory. In that case, the petitioner, a trustee of a reorganized mortgage, sought to join the Superintendent of Insurance as a party defendant in an action to foreclose the mortgage "in order to determine therein whether the unsold portion belonging to the latter is junior, subordinate and inferior to the portion held by the trustees for the benefit of the certificate holders 'as if the petitioner held a first mortgage on said premises * * * and the * * * Liquidator * * * held a second mortgage on said premises', and (2) for the purpose of cutting off said liquidator's interest if it be held to be junior and subordinate" (p. 319).

The Court denied the application, declaring that there was no justification for treating what is actually a subordinate interest in a single first mortgage as if it were in fact a second mortgage, though it recognized that the certificates held by the Superintendent of Insurance were subordinate (p. 320):

> "The certificate holders and the liquidator both own interests in the same mortgage and the trustee holds title to the bond and mortgage on their respective behalves. The action seeks to foreclose the entire mortgage and not merely that part thereof which is represented by certificates. Since the trustee has title to the entire mortgage it must be deemed to hold the same in trust for the certificate holders and for the liquidator, as their interests may appear. Title to the whole mortgage vested in the trustee after it qualified as such under the plan of reorganization. There was no splitting up of the mortgage between the trustee and the liquidator. Nor could such a split up of a single obligation be effected without the consent of those liable upon the bond and mortgage.
>
> * * * In view of the fact that the certificate holders are entitled to priority over the uncertificated unsold portion, adjudication as to such priority to be obtained

on a proper application, no payments are to be made by the trustee on account of the unsold portion until the certificate holders have been paid in full. It does not follow, however, from the fact that the right of the liquidator to share in the proceeds of the mortgage is subordinate to that of the certificate holders that the unsold portion may be treated as if it were a second mortgage and cut off as such in a foreclosure action."

POINT II

The Federal Court should follow and apply the decisions of the Court of Appeals of the State of New York.

The issues submitted for determination arise out of a contract made between citizens of the State of New York, executed and to be performed in the State of New York. This contract involves a question of commercial general law, and does not involve the construction of either the Constitution of the United States or an Act of Congress. The Court is, therefore, bound and required to follow the decision of the Court of Appeals of the State of New York, the highest court of the State of New York, the State wherein the contract was made and the controversy arose.

See *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 82 L. Ed. 1188, where Mr. Justice Brandeis, speaking for the Supreme Court of the United States, in overruling the doctrine long established by *Swift* v. *Tyson*, 16 Pet. 1, 18, 10 L. Ed. 865, 871, said:

> "Except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State. And whether the law of the State shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern. There is no federal general common law. Congress has no power to declare substantive rules of common law applicable in a State

whether they be local in their nature or 'general', be they commercial law or a part of the law of torts. And no clause in the Constitution purports to confer such a power upon the federal courts."

Mr. Justice Brandeis quoted and adopted a portion of the dissenting opinions of Mr. Justice Holmes in *Kuhn* v. *Fairmont Coal Co.*, 215 U. S. 349, 370-372, 54 L. Ed. 228, 238, 239, 30 S. Ct. 140; *Black & W. Taxicab & Transfer Co.* v. *Brown & Y. Taxicab & Transfer Co.*, 276 U. S. 518, 532-536, 72 L. Ed. 681, 686-688, 48 S. Ct. 404, 57 A. L. R. 426. We quote from *Erie R. Co.* v. *Tompkins*, supra, at page 1195:

> "The fallacy underlying the rule declared in Swift v. Tyson is made clear by Mr. Justice Holmes. The doctrine rests upon the assumption that there is 'a transcendental body of law outside of any particular state but obligatory within it unless and until changed by statute,' that federal courts have the power to use their judgment as to what the rules of common law are; and that in the federal courts 'the parties are entitled to an independent judgment on matters of general law':
>
> > 'But law in the sense in which courts speak of it today does not exist without some definite authority behind it. The common law so far as it is enforced in a State, whether called common law or not, is not the common law generally but the law of that State existing by the authority of that State without regard to what it may have been in England or anywhere else . . .
> >
> > 'the authority and only authority is the state, and if that be so, the voice adopted by the State as its own [whether it be of its Legislature or of its Supreme Court] should utter the last word.'"

"Laws" includes "decisions", said Mr. Justice Reed in *Erie R. Co.* v. *Tompkins*, supra.

The decision of the Court of Appeals of the State of New York contained in Point I constrains the Court to declare that the certificates held by The Prudence Realization Corporation, the successors in interest of the trus-

tees of The Prudence Company, Inc., Debtor, are not on a parity with those certificates sold and delivered by The Prudence Company, Inc., as guarantor, to the general public.

In the prevailing opinion, the Circuit Court of Appeals said:

> "If it is a rule of construction, we would follow it as we held in *In re Prudence Co., Inc.*, 2 Cir., 82 F. 2d 755, *certiorari* denied 298 U. S. 685, 56 S. Ct. 958, 80 L. Ed. 1405; and see, of course, *Erie R. Co. v. Tompkins*, 304 U. S. 64, 58 S. Ct. 817, 82 L. Ed. 1188, 114 A. L. R. 1487."

In *Prudence Company, Inc.*, 82 Fed. (2d) 755, cert. den. 298 U. S. 685, 56 S. Ct. 787, this Court followed and applied the decisions of the Court of Appeals of the State of New York construing contracts existing between The Prudence Company, Inc., and Prudence-Bonds Corporation with certificate holders as contracts made, executed and to be performed in the State of New York, and therefore governed by the laws of the State of New York or the decisions of the Court of Appeals. This in spite of the filing of petitions for reorganization of each of these corporations in the Federal Court under Section 77B of the Bankruptcy Act. See page 757:

> "The contract was made and was to be performed in New York concerning trust property there. We adopt the construction of the highest court in that state as to its meaning and effect. Hiscock v. Varick Bank, 206 U. S. 28, 27 S. Ct. 681, 51 L. Ed. 945; Prudential Ins. Co. of America v. Liberdar Holding Corporation (C. C. A.), 72 F. (2d) 395."

The Appellate Division of the State of New York in *In the Matter of New York Title & Mortgage Company*, supra, declared the interest held by the Superintendent of Insurance to be, "* * * actually a junior interest in a single mortgage * * *" (p. 320). The decisions of the

Courts of the State of New York are controlling as to the priority, validity and extent of the respective interests held by the guaranteed mortgage certificate holders and The Prudence Company, Inc., in the Zo-Gale Issue.

See:

Lerner Stores Corporation v. *Electric Maid Bake Shops* (5th Cir.), 24 Fed. (2d) 780, 782.

"* * *, if the property in the hands of the trustee is covered by two liens under the state law, it is necessary to determine which takes precedence, and the order of the liens fixed by the state law will be enforced. Preetorius v. Anderson (C. C. A.) 236 F. 723."

In *Re Knox-Powell-Stockton Co.* (9th Cir.), 100 Fed. (2d) 979, at page 982:

"The laws of the state where the adjudication is had are controlling as to the validity and extent of the lien. York Mfg. Co. v. Cassell, 201 U. S. 344, 26 S. Ct. 481, 50 L. Ed. 782; Hiscock v. Varick Bank, supra; Marshall v. State of New York, 254 U. S. 380, 41 S. Ct. 143, 65 L. Ed. 315."

See:

General Motors Acceptance Corporation v. *Coller* (6th Cir.), 106 Fed. (2d) 584; cert. den. 60 Sup. Ct. 723, 309 U. S. 682, 84 L. Ed. 1026.

POINT III

The decision of the Circuit Court of Appeals for the Second Circuit should be affirmed.

Respectfully submitted,

A. Joseph Geist,
Attorney for Respondent.

Morris A. Marks,
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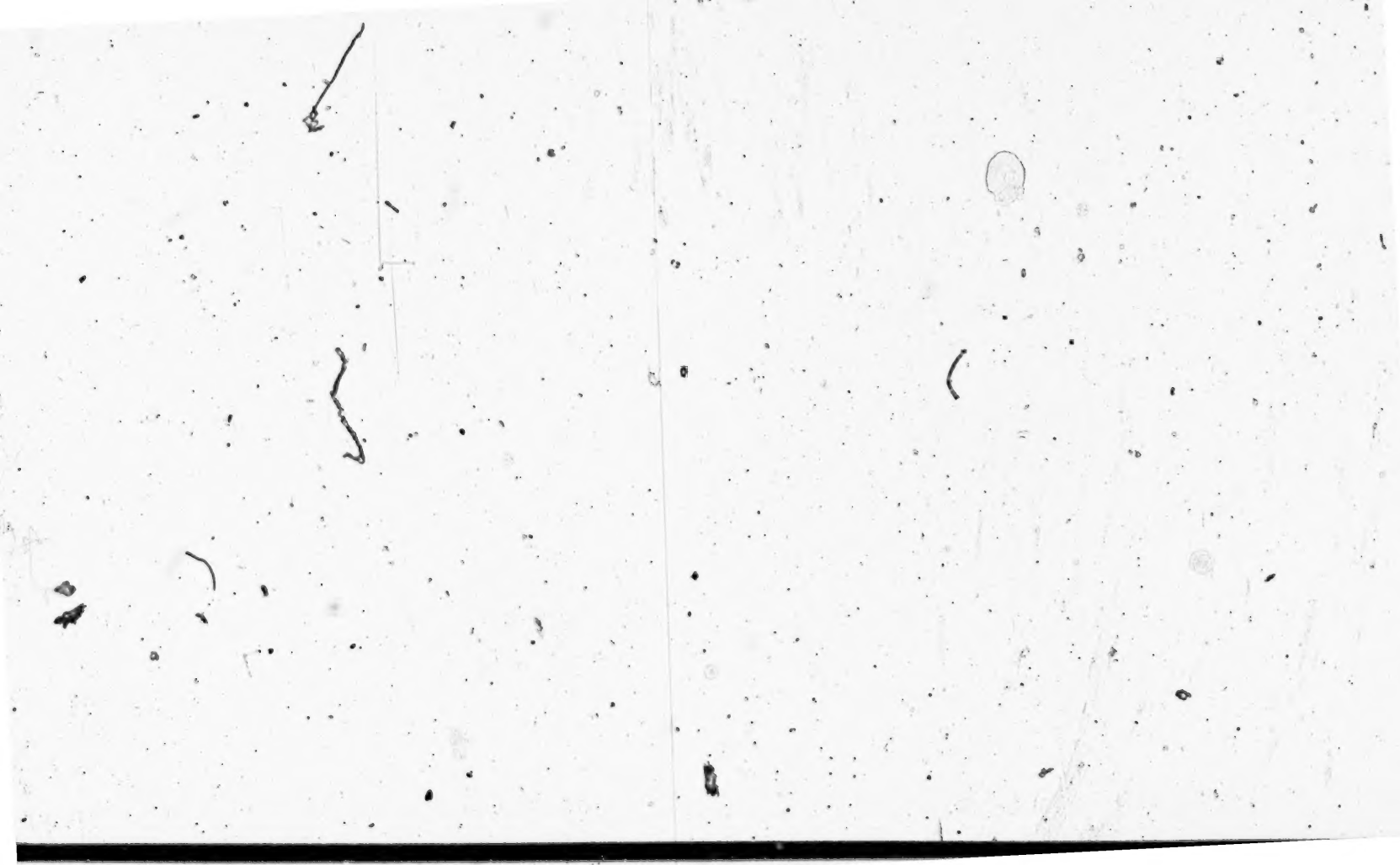

SUPREME COURT OF THE UNITED STATES.

No. 757.—October Term, 1941.

Prudence Realization Corporation, Petitioner, *vs* A. Joseph Geist, Trustee.	Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[April 27, 1942.]

Mr. Chief Justice Stone delivered the opinion of the Court.

The question for our decision is whether an insolvent defaulting guarantor of certificates of participation in a mortgage, who is also the owner of a part of the mortgage indebtedness, is entitled to share pro rata in a distribution of the proceeds of the mortgage in a § 77B bankruptcy reorganization.

Prudence Company, petitioner's predecessor, and a wholly owned subsidiary of New York Investors, Inc., loaned to Zo-Gale Realty Company $480,000 on its bond secured by a first mortgage on real estate. In 1925 Prudence Company put into execution a plan for selling participation certificates in the mortgage. It assigned the bond and mortgage without consideration to Prudence Bonds Corporation, also a wholly owned subsidiary of New York Investors, Inc. Prudence Bonds in turn lodged the bond and mortgage with a trust company depositary. Prudence Company then executed a guaranty of payment of the bond and mortgage, whereupon Prudence Bonds issued certificates of participation authenticated by the trust company, and totaling $382,800. It delivered them, without payment of any consideration, to the Prudence Company which then sold them to investors. The guaranty of Prudence Company, which was referred to in the participation certificates, was of payment of the bond interest when due and of the principal when due or within eighteen months thereafter.

Each certificate declares that the purchaser is entitled to an undivided share in the mortgage of a specified amount equal to the sum paid for it by the original purchaser. Each provides that the share in the bond and mortgage represented by it is not sub-

ordinate to any other shares or subject to any prior interest, and each reserves to Prudence Bonds the right "to be the holder or pledgee of similar shares" in the bond and mortgage. The mortgage indebtedness was later reduced to $390,000, leaving an undivided share of $7,200 of which Prudence Company wa the equitable owner, for which no participation certificate had been issued.

In 1938 an order of the bankruptcy court, in which Prudence Company and Prudence Bonds were then being reorganized, directed a transfer to Prudence Company of the $7,200 interest, as part of a settlement and adjustment of mutual claims between the two companies, and Prudence Company has continued to be the owner of this share of the mortgage indebtedness. It has also acquired by purchase from certificate holders $816.67 in certificates of participation in the mortgage.

On foreclosure of a second mortgage on the Zo-Gale property, Amalgamated Properties, Inc., a wholly owned subsidiary of Prudence Company, acquired title to the property from the mortgagor, and later went into a bankruptcy reorganization. Upon approval by the court of a plan of reorganization of the Zo-Gale certificate issue, the title to the mortgaged property was transferred to respondent Geist as trustee for the benefit of the certificate holders. In confirming the plan for reorganization of Amalgamated, the court reserved for future decision the question whether the Prudence Company was entitled to payment of its two claims in the mortgage pro rata with the other certificate holders.

As provided by the reorganization plan of Prudence Company, petitioner Prudence Realization Corporation was organized to take over the assets from the trustees of Prudence Company and to liquidate them for the benefit of creditors under the direction of the bankruptcy court. Petitioner has thus acquired certificates issued in the Amalgamated reorganization proceeding, representing the interest of Prudence Company in the Zo-Gale bond and mortgage. The claims against Prudence Company recognized by its plan of reorganization amounted to $133,723,000, including its guaranties of mortgages amounting to $12,523,000; guaranties of bonds issued by Prudence Bonds for $58,833,000; and guaranties of mortgage participation certificates issued by Prudence Bonds (including the Zo-Gale mortgage certificates) for $50,858,000.

The present proceeding was begun by respondent's petition in the consolidated reorganization of Prudence Company and Amalga-

mated Properties in the Eastern District of New York for an order directing that petitioner was not entitled to any distribution on account of the Prudence Company's interest in the Zo-Gale mortgage until the other certificate holders were paid in full. The district court granted the order, which the Circuit Court of Appeals for the Second Circuit affirmed. 122 F. 2d 503. Both courts applied the rule of the New York Court of Appeals, see *Matter of Title & Mortgage Guaranty Co.*, 275 N. Y. 347; *Pink* v. *Thomas*, 282 N. Y. 10; *Matter of People* (*Union Guarantee & Mortgage Co.*), 285 N. Y. 337, that a guarantor of mortgage certificates, who also has an interest in the mortgage, cannot share in the proceeds of its collection until the certificate holders are paid, unless there is a clear reservation in the certificate of the right of the guarantor to share on a parity with other certificate holders. The Circuit Court of Appeals by a divided court held that it was bound to apply the rule announced in the New York cases cited, which it deemed to be a rule of construction of the guaranty of the certificates. We granted certiorari, 315 U. S. —, because of the importance in bankruptcy administration of the questions raised.

The court below recognized the implication of the requirement that a plan of reorganization under former § 77B(f)(1) of the Bankruptcy Act (see 11 U. S. C. § 621(2)) be one which "is fair and equitable and does not discriminate unfairly in the case of any class of creditors", see *Southern Pacific Co.* v. *Bogart*, 250 U. S. 483, 492; *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106, and that § 65(a) requires that in liquidations a distribution of "dividends of an equal per centum" shall be made "on all allowed claims, except such as have priority or are secured", see *Globe Bank* v. *Martin*, 236 U. S. 288, 305; *Moore* v. *Bay*, 284 U. S. 4. It recognized also that the equity powers of the bankruptcy court may be exerted to subordinate the claims of one claimant to those of others of the same class where his conduct in acquiring or asserting his claim is contrary to established equitable principles. See *Taylor* v. *Standard Gas Co.*, 306 U. S. 307; *Pepper* v. *Litton*, 308 U. S. 295; *In re Bowman Hardware & Electric Co.*, 67 F. 2d 792.

But the court found it unnecessary to choose between such competing considerations, and rested its decision on the ground that Prudence Company's guaranty of the certificates was under state law to be interpreted as impliedly agreeing that any claim of its own to the mortgage indebtedness was to be subordinated to those

of other certificate holders. After referring to cases in which the New York Court of Appeals had directed such a subordination, the court said (122 F. 2d 505):

"An important issue herein is whether this is primarily a rule of construction of the guaranty in the certificates or is a rule of administration of insolvent estates which violates bankruptcy principles of equal distribution of a bankrupt estate among creditors. If it is a rule of construction we would follow it . . . ", citing *Erie Railroad* v. *Tompkins*, 304 U. S. 64. "And if we thus found the guarantee to amount to an actual agreement between two creditors that the claim of one against the debtor should be subordinated to that of the other, we should give effect to it . . . ."

The only evidence of the actual intent of the parties to which the court referred was the fact that Prudence Company, unlike Prudence Bonds, had not reserved the right in the certificates to be the holder of "similar shares" in the bond and mortgage. But there is no contention that in the absence of such a provision in the certificates, Prudence Company was not free to acquire certificates or hold an interest in the guaranteed mortgage in its own right. Consequently, its ownership of the $816.67 in certificates and $7,200 of the uncertificated indebtedness evidences no actual intention to subordinate those interests in a liquidation. And neither the terms of the guaranty nor of the certificates give any indication of such an intent of the parties.

The court arrived at its conclusion that the Prudence Company had agreed to subordinate its claims, not from an examination of the relevant documents read in the light of the surrounding circumstances, except as we have noted, but from its reading and application of the opinions of the New York Court of Appeals. These recognize that the guarantor of a mortgage, who is also a part owner of it, is free to stipulate that he may share in a liquidation on an equal footing with other owners of the mortgage despite his default on his guaranty, and that effect will be given to such a stipulation. See *Matter of Title & Mortgage Guaranty Co.*, *supra*, 352; *Pink* v. *Thomas*, *supra*, 12; *Matter of People (Union Guarantee & Mortgage Co.)*, *supra*, 343. On the other hand, some of them have found visible evidence, in the terms of the certificates, of an actual intention of the parties to subordinate the guarantor's interest. To that extent they are inapplicable to the certificates in this case, which afford no such evidence. See *Matter of Title and Mortgage Guaranty Co.*, *supra*,

355; *Matter of People (Union Guarantee & Mortgage Co.), supra,* 345.

But so far as the New York cases, without evidence of the actual intent of the parties, subordinate the guarantor on grounds of "presumed intention", or "the existence of special equities", or the "natural equities" involved, *Title Guarantee & Trust Co.* v. *Mortgage Commission,* 273 N. Y. 415, 426; *Matter of Title & Mortgage Guaranty Co., supra,* 355; *Pink* v. *Thomas, supra,* 12; *Matter of People (Union Guarantee & Mortgage Co.), supra,* 343; *Matter of Lawyers' Title & Guaranty Co.,* 287 N. Y. 264, 272, we are unable to say that the rule laid down is other than one of state law governing the relative rights of claimants in a state liquidation. Nothing decided in *Erie Railroad* v. *Tompkins, supra,* requires a court of bankruptcy to apply such a local rule governing the liquidation of insolvent estates. The bankruptcy act prescribes its own criteria for distribution to creditors. In the interpretation and application of federal statutes, federal not local law applies. See *Awotin* v. *Atlas Exchange Bank,* 295 U. S. 209; *Chesapeake & Ohio Ry.* v. *Martin,* 283 U. S. 209, 212-213; *Board of Comm'rs* v. *United States,* 308 U. S. 343, 349-350; *Deitrick* v. *Greaney,* 309 U. S. 190, 200; *Royal Indemnity Co.* v. *United States,* 313 U. S. 289, 296. The court of bankruptcy is a court of equity to which the judicial administration of the bankrupt's estate is committed, *Securities Commission* v. *U. S. Realty Co.,* 310 U. S. 434, 455-457, and it is for that court—not without appropriate regard for rights acquired under rules of state law—to define and apply federal law in determining the extent to which the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy requires its subordination to other claims which, in other respects, are of the same class. Cf. *Taylor* v. *Standard Gas Co., supra*; *Pepper v. Litton, surpra.*

But the question remains whether there is any equity arising from the Prudence Company's failure to perform its contract of guaranty which a bankruptcy court should recognize as requiring the subordination of the company's interest in the mortgage to the claims of the other mortgage creditors. It is a familiar equity rule applied by the federal courts in liquidation proceedings under federal statutes that a solvent guarantor or surety of an insolvent's obligation will not be permitted, either by taking indemnity from his principal or by virtue of his right of subrogation,

to compete with other creditors payment of whose claims he has undertaken to assure, until they are paid in full. If the surety were allowed to prove his own claim before the creditor is paid, he would to that extent diminish the creditor's dividends upon his claim, and thus defeat the purpose for which he had given the indemnity. *United States* v. *National Surety Co.*, 254 U. S. 73, 76; *Jenkins* v. *National Surety Co.*, 277 U. S. 258; *American Surety Co.* v. *Electric Co.*, 296 U. S. 133; *Peoples* v. *Peoples Bros.*, 254 Fed. 489; *United States Fidelity & Guaranty Co.* v. *Union Bank & Trust Co.*, 228 Fed. 448, 455. For like reasons equity requires the surety who holds security of the insolvent principal to give the benefit of it to the creditor for whom he is surety until the debt is paid. *Keller* v. *Ashford*, 133 U. S. 610; see *Chamberlain* v. *St. Paul, etc. R. R.*, 92 U. S. 299, 306; *Hampton* v. *Phipps*, 108 U. S. 260, 263; 4 Pomeroy, Equity Jurisprudence (5th ed.) § 1419.

But we think the equitable basis for requiring the surety or guarantor to postpone the assertion of rights which he derives from or are incidental to his suretyship, to the rights of creditors whom he has undertaken to secure, is wanting here. The rights asserted by Prudence Company in the mortgage are not those of a subrogee; they were acquired independently of its guaranty. They are not derived from or an incident to it. Their assertion is in no way inconsistent with any duty or obligation it assumed by its contract of guaranty. By that contract the guarantor pledged only its personal obligation for the payment of the certificates. It gave to the certificate holders no lien upon, or other priority right in its interest in the mortgage more than to its other assets.

Postponement of its rights in the mortgage to those of the other certificate holders is not justifiable as operating to avoid circuity of action. The Prudence Company is not solvent. Its property is being liquidated in bankruptcy where all the claimants on its present and other guaranty obligations are entitled to share equally in its unpledged assets. Denial of the right to prove its claim, which is an asset in which all of Prudence's creditors are otherwise entitled to share, will serve only to divert this asset from all creditors to one class of creditors, the Zo-Gale certificate holders, and thus give to them the exclusive benefit of a security for which they have not bargained. Allowance of the Prudence Company's claim does not involve any breach of its duty as guarantor.

Nor does it deprive certificate holders of their right to share in this asset *pari passu* with the other creditors, or of any right, legal or equitable, to which they are entitled by virtue of their position as guaranteed creditors. See *Hampton* v. *Phipps*, *supra*; *Prairie State Bank* v. *United States*, 164 U. S. 227; *Henningsen* v. *United States Fidelity & Guaranty Co.*, 208 U. S. 404.

Since the New York rule, in the absence of an actual agreement to subordinate the guarantor, is merely a general rule of law governing insolvency proceedings, it is not controlling in bankruptcy. And since in the circumstances of the present case we find no agreement and no equitable basis for depriving the Prudence Company and its creditors of the benefits of the usual bankruptcy rule of equality, the judgment below must be

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.